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DLA-91-P00121

REVIEW OF THE TRADITIONAL STOCK FUND SURCHARGE

September 1991

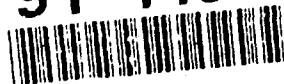
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DLA-91-P00121

**REVIEW OF THE TRADITIONAL
STOCK FUND SURCHARGE**

September 1991

Thom A. Kostenbauder

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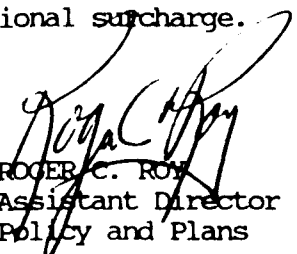
FOREWORD

The Department of Defense (DoD) is spending approximately \$30 billion per year in managing and buying supplies. The value of DoD inventory on-hand is \$100 billion and has been increasing annually. A number of initiatives, identified in Defense Management Report Decision (DMRD) Number 901, have been implemented by DoD management to reverse this trend. One directed that all costs incurred to support the stock fund mission be borne by the stock fund. Consequently all Defense Logistics Agency (DLA) supply support costs incurred by DLA Defense Depots (DD) and Inventory Control Points (ICP) are now paid with stock fund not operating and maintenance dollars.

In response to the single source resourcing initiative, the Deputy Director of DLA had a series of studies undertaken which covered several key aspects of the action. The DLA Operations Research and Economic Analysis Management Support Office (DORO) was tasked to conduct a review of the "traditional" (or pre-supply support cost) surcharge methodology.

The review found that existing guidance (including interim policy and revisions in process) on the subject is current but very broad, and that DLA's method of developing the traditional surcharge is in conformance with this broad guidance. It was noted that while long term cost recovery results were good, year to year cost recovery results fluctuate widely. Frequent change occurs in the components used to develop the surcharge rate and minor irregularities have occurred, however, no major discrepancies were noted.

The report recommends that the traditional surcharge be incorporated in the standard unit price as stated in Project DLA-XX-00191, Review of Additional Characteristics for Use in Surcharges. That project supports a "process fee plus surcharge rate" approach to cost recovery. It is further recommended that DLA standardize the procedure for computing the traditional surcharge.


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I. INTRODUCTION

A. Background. Traditionally there has been a surcharge levied against the cost of an item provided by the Defense Logistics Agency (DLA). This "traditional surcharge" has mainly consisted of elements for transportation, inventory expense, inventory maintenance and price stabilization. The expenses of procurement, warehousing, repacking and handling, or any other operational function of supply administration pertaining to the stock fund were not included in the Standard Unit Price (SUP). However, Defense Management Report Decision (DMRD) Number 901 directed that support costs originally funded by Operation and Maintenance (O&M) appropriations be moved to the stock fund. These support costs are now included in the SUP using an "operational surcharge." The Deputy Director, DLA, asked that the DLA Operations Research and Economic Analysis Management Support Office (DORO) review the original elements of the stock fund surcharge. This tasking expands an earlier project that was requested by the DLA Office of Comptroller (DLA-C), which was designated to review only selected elements of the traditional surcharge. In accordance with the tasking from the Deputy Director, the DLA Operations Research and Economic Analysis Office (DLA-LO) rescoped the project to include an in-depth evaluation of all the traditional elements of the surcharge.

B. Objectives

1. Determine whether DoD/DLA guidance for calculating the traditional surcharge is current and accurate.
2. Determine whether DLA calculations of the traditional surcharge follow existing DoD/DLA guidance.
3. Compare traditional surcharge calculations with operational surcharge calculations for conflict and/or duplication.
4. Determine the impacts of any differences between what the traditional surcharge should be and DLA estimates.

C. Scope. This report focuses on the traditional surcharge component of the SUP of a DLA item. Both the item acquisition cost and supply support costs (operational surcharge) are secondary considerations. The study limits the survey of official guidance governing the surcharge to DoD and DLA level documentation. Review of surcharge rate development centers on Headquarters (HQ) DLA involvement as opposed to the DoD role in this process. A primary input source to the HQ DLA generation of the surcharge rate is Defense Supply Center (DSC) provided accounting data. Since it is believed that all hardware supply centers function in a similar manner, the Defense General Supply Center (DGSC) was used to review DSC involvement in surcharge development because of proximity.

II. METHODOLOGY

A. Sources of Data

1. DLA Office of Comptroller (DLA-C). The primary source of stock fund and surcharge data at HQ DLA is the Office of Comptroller, Revolving Fund Budget Division (DLA-CR). Staff personnel in this office provided information relative to the DLA-C and Office of the Secretary of Defense (OSD) roles in the development of the traditional elements of the surcharge. The primary information supplied took the form of the DLA Stock Fund, FY 92/93 Budget Submission and related financial reports.

2. DGSC Office of Planning & Resource Management (DGSC-R). Indications are that the four hardware centers followed essentially the same steps in the establishment of their individual commodity surcharges. Consequently the Office of Planning & Resource Management, Stock Fund Budget and Pricing Branch at the Defense General Supply Center (DGSC-RRS) was identified and used as the primary source of Center level surcharge establishment data. This data supplied for the most part consisted of "Analysis of Surcharge" reports, other financial reports and guidance documentation.

3. Government Publications. A literature search was conducted on the topic of stock fund surcharges. The effort resulted in the identification of the following primary guidance documents used in this report:

a. DoD Regulation 7420.13-R, dated June 1986, subject: Stock Fund Operations.

b. DoD-C Memorandum, dated 9 July 1990, subject: Interim Stock Fund Policies.

c. DMRD 901, subject: Reducing Supply System Costs.

d. DLA Manual 7000.1, dated August 1980, subject: Accounting and Finance Manual (particularly Chapter 7, Section VIII, Standard Pricing) and, in-process revisions to this document.

B. Details of Study Methodology

1. Determination of Currency and Accuracy of Guidance. The general approach taken to meet this objective was a comprehensive search (and subsequent review and analysis) of official government instructions, manuals, regulations, directives, policies, reports and related literature on stock funds, standard pricing, surcharges, single source financing, and similar subjects. These documents and interim changes thereto were then compared to DMRD 901 for consistency. After the identification and complete review of all pertinent documentation, analysis resulted in the

development of three primary areas of interest. These areas are as follows: the elements of the DLA surcharge, the purpose or objective of the surcharge, and the officials or organizational units responsible for the various aspects of the surcharge.

2. Determination of Conformity of DLA Calculations. The method to determine DLA conformity to guidance in surcharge rate development consisted of a top down identification of statistical and financial DoD/DLA/DSC documentation (budget submissions, exhibits, forms, reports and analyses) prepared in establishing the total surcharge. This approach required that surcharge derivation be tracked back to its smallest unit of record which, in most cases, were individual control and subsidiary general ledger account codes. This activity resulted in the identification of the complete mathematical structure used in surcharge development. This structure was then compared to the current DoD/DLA guidance.

3. Comparison of Traditional and Operational Surcharge Element. The procedure to compare the traditional and operational surcharge involved the identification of the specific funding source and individual account categories used in setting both surcharges. A comparison at the source account level was then made. The objectives of both surcharges were also compared for conflict.

4. Cost Recovery Effectiveness. To determine the effectiveness of DLA-CR in recovering traditional surcharge expense elements through setting surcharge rates, the actual expenses incurred were compared to the dollars set aside for that expense through surcharge collections. Surcharge collections set aside can be determined by the formula: (Purchase Price of the Item to DLA * Surcharge Percentage for the Expense Element) * Number of Units Ordered = Surcharge Collected on Order.

III. RESULTS

A. Determination of Currency and Accuracy of Guidance. Review of DoD/DLA documentation, including revisions and interim policy, show that the surcharge is composed of a number of separate expense elements and surcharges. The documentation also provides standard pricing (and therefore) surcharge objectives. Both surcharge expense elements and objectives are discussed below.

1. Expense Elements

a. Transportation Expense. The first surcharge element is designed to recover transportation costs incurred by DLA in providing goods to its customers. The transportation surcharge contains two components. The First Destination Transportation Expense Surcharge covers those transportation costs incurred in moving goods from the point of origin (vendor/supplier) to the point first received (DLA) for use or for storage for subsequent distribution. The Second Destination Transportation Expense Surcharge is used to recover transportation expense incurred in transferring goods from supply depots to DLA customers.

b. Inventory Losses. Like the transportation surcharge the inventory loss surcharge element also has two parts, each constructed to compensate the Defense Stock Fund for all foreseeable losses on current procurements. The primary surcharge under this category is the Wholesale Inventory Losses Surcharge. This surcharge is an aggregation of some 20 plus general ledger accounts and authorized expenses including pilferage, shrinkage, deterioration, obsolescence, disposal and physical inventory adjustments. Retail Inventory Losses is the second component of this cost category and represents an agreement reached by DLA and the Military Services on losses sustained on goods which have departed the DLA supply depot (wholesale) stage. Such losses are deducted from billings to stock fund customers.

c. Inventory Maintenance. DoD 7420.13-R identifies Inventory Maintenance as a separate surcharge element. However, DLA-CR advised that this element has not been calculated separately since FY87 as it is accounted for in the inventory loss surcharge element discussed in II.B.2) above. See paragraph III.B. below for more discussion on this topic.

d. Other Surcharge Elements. This includes a bulk fuels surcharge used to compensate the Defense Stock Fund for Bulk Petroleum, Oil and Lubricants (POL) Service expenses. This element is unique to the pricing of POL products and in no way affects the pricing of DLA's other products. Another element is the Price Stabilization Rate, the sum of an inflation rate and a stabilization rate, provided by OSD(C) and not calculated by DLA. These Other Surcharge Elements are not considered except indirectly in the remainder of this report.

e. Supply Support (Operating) Cost Element. These elements are the cost of materiel; acquisition management; inventory management, receipt, storage, and shipping of materiel (not covered in the transportation element above); and immediate support costs (facilities and administration) incurred by DLA Inventory Control Points and Defense Depots (ICP/DD). Other non-ICP/DD costs are also considered in the Operating Costs element. For example, portions of the DLA Defense Finance Center and Defense Systems Automation Center costs are included. Guidance relative to supply support costs are found in interim policy and revision documentation.

2. Surcharge Objectives. Although the surcharge is composed of several definable elements, the ultimate purpose of the surcharge is to maintain an approved level of funds with Treasury. In other words, the basic objective of standard pricing (through the application of an appropriate surcharge) is to provide a relatively uniform, equitable, and practical means for collecting the replacement cost and associated expenses incurred by DLA through the sale of DLA-managed items.

3. Review of Guidance. Review shows DoD/DLA guidance both current and accurate with the qualification that interim and in process revisions are included in the determination of currency.

B. Determination of Conformity of DLA Calculations to Existing Guidance.

1. The official guidance set forth in DoD and DLA documentation for the establishment of surcharge rates is extremely broad. In essence the documentation directs that certain major expense elements be "considered" and that costs incurred be recovered. Responsible officials are given little specific guidance and, consequently, have significant latitude in determining how cost dollars are converted into surcharge percentages. The process that has evolved includes qualitative as well as quantitative input.

2. For the most part the quantitative input is developed at the supply centers in the form of "Analysis of Surcharge" reports. See Appendix B for a detailed illustration of the results of this analysis for DGSC. Upon completion of this report the centers forward to DLA-CR their recommendation as to what the surcharge rate should be for the Wholesale Inventory Losses, Retail Inventory Losses, First Destination Transportation Expenses, and Second Destination Transportation Expense elements.

3. DLA-CR receives the center surcharge recommendations and, after making qualitative adjustments to the recommended values to take into consideration upcoming changes in policy and other subjective influences, sums the four surcharge expense elements to create the commodity surcharge for each center. To this value is added the price stabilization rate. The Price Stabilization Rate is set by OSD. Lastly an "other" or miscellaneous category rate is added. The total of all these values is referred to here as the "traditional" surcharge rate for the commodity. Since DMRD 901 moves supply support (operating) costs under the stock fund, an "operational" surcharge is also computed and added to the traditional surcharge rate to produce the so-called "total surcharge rate." This rate is the value applied to the acquisition cost to produce the DLA standard price for the item.

4. The DoD/DLA guidance is so broad as to allow significant latitude in interpretation. Although DLA calculations conform to this broad guidance, it was noted that the methodology for constructing the surcharge varies somewhat from year to year. For example: account expenses reported at their full amount 1 year are reported at a fractional amount the next; using the actual account expense total in one time period and using a multiple year average in a succeeding time period; in one time period using different time frames for producing multi-year averages for two different cost accounts; and sometimes including and sometimes omitting the same general ledger account code in successive years. Another example of methodology change involves the apparent discontinuance of the inventory maintenance surcharge element in FY87. DLA-CR suggests, however, that this surcharge element (which, as stated in DoD 7420.13-R, is used to finance inventories required over and above demand replacement) may be looked upon as having been absorbed in the inventory loss element.

C. Comparison of Traditional and Operational Surcharge Elements

1. The traditional surcharge is composed of four cost elements, two relating to inventory losses and two relating to transportation expenses. Cost values associated with these elements are recorded as specific general ledger account codes under the Stock Fund. The operational surcharge is composed of supply support costs from two DLA organizational units, namely ICPs and DDs. Prior to the implementation of DMRD 901 these ICP/DD operating costs were funded through the Agency's O&M appropriation. The single source financing initiative combines all costs, traditional as well as operational, under the stock fund.

2. Comparison of the two surcharges, traditional and operational, has revealed no major discrepancies, conflict in surcharge development or duplication of costs between the two surcharges.

D. Cost Recovery Effectiveness. To examine DLA's success in meeting the surcharge objective of cost recovery, DGSC accounting data was used. The data was for a 6 year period beginning with FY85 and going through the first 8 months (31 May 1989) of FY90. The data in Table 1 shows the amount of surcharge dollars collected versus actual inventory loss and transportation expense incurred by the center. While the year to year cost recovery results ranged widely, from -35.0 percent to +70.8 percent, surcharge collected dollars exceeded, over the 6 year period, actual expenses incurred by only 5.5 percent. It is noted that the large difference between collected and actual expenses in FY88 is due to a large increase in wholesale losses which was caused by excluding receipts of materials returned without credit from surcharge calculations. See Appendix B for a more detailed breakout.

Table 1

SUMMARY SURCHARGE COST RECOVERY*

General Commodity FY 1985 - 1990** (in millions of dollars)							
	FY85	FY86	FY87	FY88	FY89	FY90	TOTAL
Total Commodity Expense							
Collected	57.3	44.8	45.7	40.8	38.8	26.7	254.1
Actual	45.5	41.5	26.7	62.8	45.3	19.0	240.8
Difference	11.9	3.3	18.9	(22.0)	(6.5)	7.7	13.3
Collected expense exceeded /fell short of (-) actual expenses by this %...	26.0%	8.0%	71.2%	-35.0%	-14.3%	40.5%	5.5%

* Figures may vary slightly from Appendix B due to rounding.

** FY90 is for the months of October 1989 through May 1990 only.

IV. CONCLUSIONS

A. Existing official guidance on the surcharge is current and accurate.

B. The method of computing the surcharge rates at DLA is in conformance with official documentation.

C. No major discrepancies were noted within or between the traditional and operational surcharges.

D. Minor irregularities, methodology inconsistencies and wide swings in cost recovery results occur.

E. Long term (1985-1990) cost recovery effectiveness was acceptable.

V. RECOMMENDATIONS

A. The traditional surcharge should be incorporated in the standard unit price as recommended in project DLA-XX-P00191, Review of Additional Characteristics for Use in Surcharges. That project supports a "process fee plus surcharge rate" approach to cost recovery.

B. Standardize the procedure for computing the traditional elements of the surcharge.

APPENDIX A

Glossary

1. Acquisition Cost - is the price DLA pays to vendors for goods and products. This cost is similar to the wholesale price and may also be referred to as the current market or production cost.
2. Commodity Surcharge - is a subset of the overall surcharge rate and is composed of the transportation expense and inventory loss surcharge elements only and excludes the inflation, stabilization and operating expense elements. Each major materiel category has a commodity surcharge.
3. Operational Surcharge - identifies the supply support (operating) expense element of the current surcharge rate. This element was added to the overall surcharge development formula in response to DMRD 901. See Traditional Surcharge below. Prior to being made part of the surcharge all supply support expenses were incurred by ICP/DD and were financed through the O&M appropriation.
4. Single Price - each catalogued item with a national stock number assigned which is managed by a DoD Inventory Control Point (except for a subsistence item sold to a commissary) shall have one standard price for all sales to DoD and Coast Guard customers.
5. Standard Price - the single, system-wide price established by Defense Supply Centers for each centrally managed national stock numbered item procured and supplied through the Defense Stock Fund to DoD and Coast Guard customers. The standard price consists of two basic elements: the acquisition cost for material and a surcharge.
6. Surcharge - a percentage rate that when multiplied by an item's acquisition cost produces a value which when added to the item acquisition cost establishes the standard price of that item. The surcharge is used to recover specific costs associated with items for sale to DLA customers.
7. Surcharge Elements - are groupings of similar costs and expenses incurred by DLA in its mission of providing goods for sale to customers. The primary elements are: transportation expenses, inventory losses, supply support costs, and stabilization and inflation rates.
8. Traditional Surcharge - identifies the surcharge (and expense elements) in use prior to adding the supply support (operating) expense element to the overall surcharge rate. Traditionally, the only surcharge expense elements recovered were transportation, inventory loss, and stabilization and inflation rates. All traditional surcharge expenses are financed through the stock fund.
9. Total Surcharge Rate - is the combination of all surcharge elements: Wholesale Losses, Retail Losses, First Transportation Expense, Second Transportation Expense, Inflation Rate, Stabilization Rate, Other Category Rate, Operating Cost Rate.

APPENDIX B

REVIEW OF SURCHARGE COST RECOVER/ FOR THE GENERAL COMMODITY (FISCAL YEAR 1985 - 1990*, \$,000 OMITTED)

FISCAL YEAR	FY85	FY86	FY87	FY88	FY89	FY90*	Six Year Total
Purchases at Cost	\$770,704	\$803,902	\$782,310	\$697,989	\$634,858	\$430,755	\$4,120,518
Wholesale Losses							
Collected(1)	\$15,285	\$2,443	\$2,283	\$2,041	\$32,828	\$22,593	\$77,473
Actual(2)	\$2,660	\$4,039	\$1,249	\$37,091	\$40,096	\$15,414	\$100,549
Difference	\$12,625	(\$1,596)	\$1,034	(\$35,050)	(\$7,268)	\$7,179	(\$23,076)
Retail Stock Losses							
Collected	\$3,822	\$4,071	\$3,805	\$3,402	\$2,984	\$2,054	\$20,138
Actual	\$3,463	\$3,423	\$3,017	\$2,131	\$2,130	\$1,478	\$15,642
Difference	\$359	\$648	\$788	\$1,271	\$854	\$576	\$4,496
1st Dest. Trans. Expense							
Collected	\$7,645	\$8,142	\$7,610	\$6,805	\$2,984	\$2,054	\$35,240
Actual	\$7,944	\$7,744	\$2,909	\$3,435	\$3,050	\$2,113	\$27,195
Difference	(\$299)	\$398	\$4,701	\$3,370	(\$66)	(\$59)	\$8,045
2nd Dest. Trans. Expense(3)							
Collected	\$30,578	\$30,125	\$31,966	\$28,579	\$0	\$0	\$121,248
Actual	\$31,408	\$26,240	\$19,558	\$20,179	\$0	\$0	\$97,385
Difference	(\$830)	\$3,885	\$12,408	\$8,400	\$0	\$0	\$23,863
Total Commodity Expense	FY85	FY86	FY87	FY88	FY89	FY90*	TOTAL
Collected	\$57,330	\$44,781	\$45,664	\$40,827	\$38,796	\$26,701	\$254,099
Actual	\$45,475	\$41,446	\$26,733	\$62,836	\$45,276	\$19,005	\$240,771
Difference	\$11,855	\$3,335	\$18,931	(\$22,009)	(\$6,480)	\$7,696	\$13,328
Collected expenses exceeded /fell short of (-) actual expenses by this %	26.07%	8.05%	70.82%	-35.03%	-14.31%	40.49%	5.54%

* FY90 is for the months of October 89 thru May 90 only.

(1) These costs are projected using the current surcharge and the purchase cost.

(2) These costs are the sum of all charges actually paid over the year.

(3) Starting in FY89 these costs were recorded at the HQ level only. Total DIA Actual 2nd Destination Expenses were \$107.1m in FY89 and \$87.1m in FY90.